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Does the US Need a new trade policy?

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1. Introduction

The assertion that the US needs a new trade policy – on the assumption that the US has been embracing multilateral free trade as an objective, an assumption that is itself somewhat dubious, to say the least – has come from several politicians, often among the Democrats, and indeed in varying ways from a handful of economists, some of whom are on the Panel today. Yet, I wish to argue that this is a flawed demand.

It comes in several ways from the politicians. At Columbia University some months ago, for instance, we had a Panel on which Charlie Rangel, my Congressman (as Harlem is behind Columbia), declared with a flourish: so far, under the Republicans, trade policy was designed to serve the interests of corporations; now, with Democrats in control of the Congress, it will be re-designed to serve the people. An intellectual or an economist who specializes on international trade would find this amusing, to say the least. But it is a sentiment that goes well beyond the likes of the "anti-trade" or "trade-skeptical" Congressmen Bernie Sanders and Sherrod Brown.

The question of importance for us today is whether Obama believes that also. The jury is out on the issue as, since his election, Obama has – as I argue in my op-ed. "Obama and Trade: An Alarm Sounds," *Financial Times*, January 8, 2009, – failed to issue emphatically (unlike Prime Minister Gordon Brown) a strong endorsement of the Doha Round and of the WTO. In fact, he has not taken care to affirm resoundingly that the auto bailout will be done in a manner consistent with the 1995 WTO rules on Subsidies and Countervailing Measures aimed at specific firms or industries, designed to extend to subsidies the rules that GATT included (based on the widespread enactment of tariff barriers following the Smoot-Hawley Tariff of 1930) regarding tariffs to prevent an outbreak of mutually damaging trade policy measures aimed at diverting an insufficient aggregate world demand to one's own goods.

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But the politicians tend to reflect *either* what they think, often as a result of media stories, the economists believe to be true on the issue at hand *or* they simply accept what their constituents demand. In regard to trade policy, both these factors have been undermining commitment to free trade without any justification. Let me speak to these two problems.

2. Economists running away from (gains from) free trade?

2.1. Alan Blinder

The media have been running with stories, latest thanks largely to Alan Blinder's 2006 *Foreign Affairs* alarmist article on outsourcing of services online, that the academic economists' consensus on (gains from) free trade has vanished. The fact is that – as I have noted in debating Blinder at Harvard, in my lead contribution to the volume edited by Ben Friedman for MIT Press (2009) and available on my website www.columbia.edu/∼jb38 under the title "Do Not Cry for Free Trade" – Blinder is saying, in the end, nothing more than that services have become tradable and hence "vulnerable" to being lost to the outside world; and that we need therefore adjustment assistance to cope with that.

But Adjustment Assistance Programs started in 1962 under President Kennedy and have been revised repeatedly with almost every trade expansion legislation since. Besides, trade economists have analyzed the rationale for, and the optimal design of, Adjustment Assistance Programs since as early as beginning 1970s (see Bhagwati, ed. *Import Competition and Response*, NBER, Chicago University Press, 1982) The Litan-Lawrence-Brainard advocacy of an insurance program which would also cover a large fraction of the reduction in pay that would arise as people were bumped into employment down the job ladder is the latest, and the most interesting, variation in adjustment that has come our way.

Trade economists therefore see Blinder as saying nothing new, and indeed nothing whatsoever that undermines the conventional case for free trade. In fact, we have been worried for many years now that the developing countries, whose leaders have realized that freer trade is a key to their prosperity, are afraid to shift to freer trade because many of them do not have the political safety net provided by Adjustment Assistance Programs. I have argued for years therefore, and now there is concession to this viewpoint and emerging action under the "Aid for Trade" programs, that these countries be provided with funds and expertise to have Adjustment Assistance programs as well. It is hard to ask a trapeze artist to walk out on the high wire if there is no safety net.

I might also add that the recent variation by Blinder, that increase in the number of traded sectors and hence "vulnerable" jobs means that Adjustment Assistance funds should rise pari passu is not as plausible as it seems. To take an imperfect analogy just in order to bring home the point: if a safety net is created for one trapeze artist, it will serve equally for twenty of them as long as they go on the high wire sequentially. Everything depends therefore on the nature of the shifts in comparative advantage that drive the shifts in specialization among countries.

2.2. Paul Samuelson

Far more important was the stir crated by Paul Samuelson's 2004 *Journal of Economic Perspectives* article that was played up by the media as a capitulation by arguably the leading economist in the world to the cause of protectionism. Yet, it was nothing of the kind, as I and all prominent trade scholars noted.

Samuelson, who seemed to be concerned that globalization was being thought of glowingly as a situation where *anything* that happened abroad was good for the United States, was pointing out simply – though within a mathematical model that few could understand outside of the trade economists – that any exogenous change could diminish the gains from trade of a country and hence harm it. Thus, if Florida was hit by a hurricane, Florida could be harmed (though if India received a good monsoon, India would profit from that exogenous event). But the key question was: should then the Governor of Florida respond by prohibiting Florida's trade with the rest of the US? Obviously not. In Samuelson's case, therefore, if the exogenous change (like China's or India's rise) was reducing US income by reducing the US gain from trade, a protectionist response would only *add* to the loss caused by that exogenous change. There was no cause here for protectionists to rejoice!

But the AFL-CIO and EPI (Economic Policy Institute) spokesmen – I speak from having encountered them at Harvard on another occasion – persisted in this *non sequitur*. Not surprisingly, Senator Hillary Clinton cited Paul Samuelson, whom she obviously had not understood, during the primary campaign when she spoke out against free trade and in favor of a "pause" in all trade negotiations. Yet, even the Clintons, much as they like to think otherwise, are not the infallible policy wonks that they fancy themselves to be. [Recall Bill Clinton's gaffe at the Seattle WTO meeting in 1999 on labour standards that undermined the talks, and his recent gaffe on Global Warming on the Tim Russet show where he confused Global Warming with domestic pollution in India].

2.3. Others: for example, Baumol and Gomory

The Samuelson article, as also Blinder's, was in fact feeding into the frenzy over the rise of China and India as major players. As they acquired know-how and accumulated capital rapidly, registering massive growth rates, the fear was that they would be exporting skills and capital-intensive goods in which we specialized; and that this would diminish our gains from trade. But this view does not take into account the fact that as countries get to similar in endowments, trade in similar products – known also as intra-industry trade and as trade in "variety" – also breaks out and yield gains as well. Just walk down Madison Avenue in New York or Bond Street in London and you will see several designers working in the same industry but with different niches and never asking for protection: Calvin Klein, Georgio Armani, Pierre Cardin, St. Laurent, Kenzo and others. Samuelson was absolutely correct in pointing to a downside outcome as a possibility from the exogenous changes, say in India and China; but surely that possibility was a low-probability event once we took into account the possibility of gains from intra-industry trade that economists have known about for long and whose massive importance has been recently estimated by my distinguished student Robert Feenstra and independently by my Columbia colleague David Weinstein.

William Baumol and Ralph Gomory (the great mathematician) have recently joined in the fray and argued, drawing on their book of 2000, that our technology may diffuse abroad and that this would cause Samuelson-type losses of gains from trade. Even if this is true, which I doubt as I have argued in regard to the Samuelson argument, it is hard to see what operational policy response follows from this. Technology is hard to bottle up; it diffuses at varying speeds, especially in sectors like software. Besides, if it means greater intellectual property (IP) protection, there are competing schools of thought which argue for freer dissemination of technology for better welfare outcomes for the technology-producing countries, and for world welfare as well, in more complete models. [The issue whether IP should have been put into the WTO in 1995 is a different one where I believe that it was a mistake to have done so since IP is not a trade issue but one of royalty collection. Its inclusion in the WTO, at the insistence of the US, with both USTRs Mickey Kantor and Carla Hills successively supporting it wholeheartedly, has corrupted the trade institution's focus simply to please the US IP lobbies. Incidentally, this is a good example, like the Smoot-Hawley Tariff of 1930, where bipartisan consensus is no guarantor of virtue: a lesson that President Obama must remember.]

But Baumol and Gomory have also asked for industrial policy in models of increasing returns, arguing that scale economies can lead to multiple equilibria and that we would want to move to better equilibria by industrial policy nudging. We know about multiple equilibria, from conventional treatment of the subject within models where perfect competition is kept intact, by R.C.O. Matthews and James Meade nearly 50 years ago (and they are the stuff of standard graduate textbooks like the ones by Murray Kemp, for decades), and in more recent imperfectly competitive models from the early work of Paul Krugman. The only question for policy is: *who* can calculate better equilibria than the observed ones and then shift to them by industrial policy? Frankly, I have seen nothing that I would buy into. So, my reaction to the recommendation to depart from free trade and into sectoral industrial policy is what I learnt from Robert Solow when he remarked about externalities as an argument for industrial policy favoring some sectors: "I know that there are industries where the social output is four dollars whereas the private is one. My problem is that I do not know which industries these are." The political problem is that, by contrast, every industry knows that it is the one that has this externality and should get support!

3. Fear by the unions that trade is harming workers' wages (and culpability of a few economists on this issue)

But it is the distributional argument, i.e. the fear on the part of the labour unions that trade with the poor countries is driving down our workers' wages, i.e. as I put it: *trade with the poor countries is creating paupers in our midst*, that has made the unions adamant that free trade with poor countries (and outward flow of equity investment by multinationals) poses a threat and must be curtailed. With the unions now critical supporters of the Democrats, this fear has come to dominate the Democratic Party and is the most disturbing constraint on trade policy by President Obama as well. But the argument is far from plausible.

There is now almost fifteen years of empirical work, including my own, on the subject of "trade and wages" and it is fair to say that no smoking gun has been found. In fact, my empirical work demonstrates that, if anything, the effect of trade in labour-intensive foods coming from East Asia in the 1980s, then from China in the 1990s, has been to increase, not reduce, the relative prices of labour-intensive goods because these countries have rapidly accumulated capital and acquired know-how, so that the general-equilibrium effects of these two phenomena have made labour-intensive goods less rather than more abundant, *ceteris paribus*. So, the Stolper–Samuelson effect has been to moderate, not accentuate, the fall in real wages that would have accrued from rapid and acute labour-saving technical change in the rich countries. The recent work of Robert Lawrence (published by the Peterson Institute of International Economics, 2008) arrives at a similar conclusion but focuses rather on the argument that the US has by now specialized out of highly labour-intensive goods and that any decline in their world prices only benefits our workers as consumers while not having any adverse Stolper–Samuelson like effects as producers. Besides, the work of Arvind Panagariya (*Journal of International Economics*, 1988) has demonstrated the analytical problems that afflict and cripple the work of Richard Freeman, Larry Katz and George Borjas that relies on the so-called "factor content" approach: it has nothing meaningful to say about how trade affects wages in any meaningful manner, as I discuss in a substantial World Bank Lecture on *The Critiques of Free Trade: A Refutation*, (November 15th, 2008, on my website). Nor does the recent attempt by Paul Krugman, in a 2008 Brookings Conference, to conclude that increased trade with the poor countries had led to pressure on the workers' real wages in the US, get off the ground.

So, the unions remain captive to an unsupported fear. But it undermines the trade policy position of the Democrats and, it would seem, of Obama's as well, in two important ways.

First, it leads them into the assertion that free trade cannot be pursued without "fair trade", and this means that we must ask the poor countries to raise their labour (and domestic environmental) standards close to ours. This demand is frankly motivated by self-interest: the unions are worried by competition from the poor countries, as I have discussed. So, why not raise their cost of production closer to ours by getting them to have standards close to ours, thus "leveling the playing field"? This is what economists call *export protectionism*: instead of import protectionism which is hard to get, try to reduce competition through getting your rivals' production costs to go up. It is also great to play this card as your self-interest can be masked as altruism: we really want to do this for the workers abroad, out of "solidarity"! The assertion of altruism is faintly repugnant to many in the poor countries as they see through the masquerade of altruism. Besides, it is astonishing that a country such as the US, where unionization has collapsed to almost less than 10% of the private labour force (and largely because the right to strike has been crippled by the draconian Taft-Hartley legislation over half a century), should have the effrontery to ask other countries for matching labour standards. I have heard it said: If you are so keen to impose "fair trade" requirements on others in shape of labour standards, please shut off all your own exports as your own labour standards are abysmal: like charity, "fair trade" begins at home! The same applies to the changed demand for implementation of the "core" ILO standards: the US itself has not ratified a fair number of them!

Second, in a similar vein, focus on "fair trade" labour provisions in trade treaties shifts focus on the unsupported view that trade with the poor countries is at the root of our worker's plight, instead on the fact that we need to change the legislation that has weakened the unions by helping to decimate their effectiveness and hence ability to grow membership. Essentially, that was the difference between AFL-CIO, with John Sweeney as its CEO, which wanted to focus on trade as the culprit and the breakaway unions under SEIU's leadership headed by Andy Stern which wanted to focus on union membership. There is little doubt that the latter is the way to go; the former option is a dead end, for bad diagnosis leads to ineffective solutions and, as I have argued, also to gratuitous cynicism abroad about our hypocrisy.

4. Preferential trade agreements versus multilateralism

In fact, as I have argued in my latest *Termites in the Trading System* (Oxford, 2008) book, it is this false worry about poor-country competition that has led the unions, and other lobbies, to opt for 1930s-dicredited discriminatory arrangements such as the recent flood of Free Trade Agreements (FTAs). These are trade treaties where the US – the EU does this too –, a hegemonic power can bamboozle weak countries, tempted by the offer of preferential access to the huge US market, and also threatened by withdrawal of access under GSP otherwise, into accepting whatever the US wants them to accept by way of lobby-driven demands. So, a whole slew of trade-unrelated demands become trade-related demands, by the alchemy of superpower power play!

This does *not* work with the bigger developing countries which have a role in the WTO. Notably India and Brazil, both with democratic governments and no anti-union record – President Lula of Brazil is in fact a much more renowned trade union leader than Sweeny and Stern – strongly oppose putting trade-unrelated issues into trade treaties and institutions like the WTO. Faced with the EU demand that human rights, etc. be placed into a proposed India-EU FTA, India told the EU: go back and come back with a clean trade treaty. As John Kerry said, and I heard him myself, at Davos before he had to change his tune on seeking the Democratic Presidential candidacy: we need a "dual track approach": take labour standards to the ILO and trade to the WTO.

Will Obama get to hear these arguments (there is no evidence that his trade team contains anyone who understands them) and be able to take on the well-meaning but misguided Nancy Pelosis in the Democratic Party, and the AFL-CIO as well, in intellectual debate to wean them away from their follies? Bill Clinton merely confronted and vanquished them to get his trade agenda through after a bloody battle over NAFTA. But he did not debate and convert them. They survived only to fight another battle. Unless Obama does what Bill Clinton failed to do, little good can be expected from him on US trade policy in its many dimensions.

The author is University Professor, Economics and Law, Columbia University, and Senior Fellow in International Economics at the Council on Foreign Relations. His latest book is *Termites in the Trading System: How Preferential Agreements Undermine Free Trade* (Oxford, 2008).